

TITLE 10. CALIFORNIA DEPARTMENT OF CORPORATIONS

NOTICE IS HEREBY GIVEN

The Commissioner of Corporations ("Commissioner") proposes to adopt, repeal, and amend rules under the Corporate Securities Law of 1968 ("Corporate Securities Law") relating to the regulation of investment advisers. The Commissioner proposes to amend Sections 260.231, 260.235, 260.237, 260.237.2, 260.238, and 260.241.3; to repeal Section 260.237.1; and to adopt Sections 260.235.5, 260.238.1, 260.238.2, 260.238.3, and 260.238.4 of Title 10 of the California Code of Regulations.

PUBLIC COMMENTS

No public hearing is scheduled. Any interested person or his or her duly authorized representative may request, in writing, a public hearing pursuant to Section 11346.8(a) of the Government Code. The request for hearing must be received by the Department of Corporations' ("Department") contact person designated below no later than 15 days prior to the close of the written comment period.

WRITTEN COMMENT PERIOD

Any interested person, or his or her authorized representative, may submit written comments relevant to the proposed regulatory action to the Department addressed to Karen Fong, Office of Legislation and Policy, Department of Corporations, 1515 K Street, Suite 200, Sacramento, California, 95814-4052, no later than 5:00 p.m., October 30, 2007. Written comments may also be sent to Karen Fong via electronic mail at regulations@corp.ca.gov or via fax at (916) 322-5875. If this day is a Saturday, Sunday or state holiday, the comment period will close at 5 p.m. on the next business day.

INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW

The Department licenses and regulates investment advisers under the Corporate Securities Law (Corporations Code Section 25000 et seq.). Under the Corporate Securities Law, it is unlawful for an investment adviser to conduct business without first applying for and securing a certificate, as specified.

This regulatory action will increase uniformity with other states' investment adviser regulations by paralleling changes in the North American Securities Administrator's Association ("NASAA") model rules. This action will also increase consistency, when applicable, with recently modified or adopted Securities and Exchange Commission ("SEC") rules and interpretations.

Section 260.231

The proposed amendments to this section will incorporate the April 23, 2007, upgrade to the Investment Adviser Registration Depository (IARD) system and require investment advisers to file Part 2 of Form ADV with the Department electronically through the IARD system.

Section 260.235

The amendments to this section will incorporate principles governing performance-based advertising set forth in the 1986 SEC No-Action letter involving Clover Capital Management ("Clover"). The section will parallel the principles set forth in Clover by prohibiting performance-based advertisements that:

- Fail to disclose the effect of material market or economic conditions on the results advertised.
- Fail to disclose the extent to which the advertised results reflect the reinvestment of dividends or other earnings.
- Fail to disclose all material facts necessary to avoid any unwarranted inference.
- Suggest or make claims about the potential for profit without disclosing the potential for loss.
- Omit any of the facts material to the performance figures.
- Fail to reflect the deduction of advisory fees, brokerage, or other commissions, and any other expense that a client would have paid or actually paid.

Section 260.235.5

This proposed rule will require investment advisers to deliver to each prospective advisory client a written disclosure statement or brochure, describing the adviser's business practices and educational and business background. The required disclosure consists of Part II of Form ADV, the registration form for investment advisers.

Section 260.237

The amendments to this section will define the term "custody" in the context of client funds or securities. In addition to defining the term "custody," the amendments will also require that advisers with custody maintain assets with a qualified custodian, as defined in the rule. The rule will require that the investment adviser have a reasonable belief that a qualified custodian holding the assets is providing periodic account statements to clients.

Section 260.237.1

This section is being repealed because it is no longer operative.

Section 260.237.2

The amendments to this section will eliminate the reference to Section 260.237.1

(10 C.C.R. 260.237.1) that became inoperative on January 1, 2005, and will strike the previous definition of custody found in subsection 260.237.2(e), and instead cross-reference the proposed definition of custody found in the amendments to Section 260.237(c)(1) (10 C.C.R. 260.237).

Section 260.238

The amendments to this section will specify that certain activities do not promote “fair, equitable, and ethical principles,” as that phrase is used in Section 25238 of the Corporations Code.

Specifically, the proposed changes will provide that the following acts constitute an unethical business practice:

- Failing to adopt procedures designed to prevent the misuse of material nonpublic information, as required by proposed Section 260.238.1.
- Requiring a client to waive protections created by the rules of the Commissioner.
- Engaging in any conduct unlawful under the rules of the Commissioner.

Section 260.238.1

In general, this proposed rule will require investment advisers to adopt procedures designed to prevent the misuse of material nonpublic information, and will require investment advisers to adopt reporting procedures concerning personal securities transactions by supervised employees. This proposed rule largely mirrors the SEC’s Investment Adviser Code of Ethics (17 CFR 275.204A-1).

More specifically the rule would require the adoption of:

- A code of ethics that reflects the fiduciary obligation of the investment adviser, and its supervised persons.
- Procedures requiring supervised persons to comply with applicable federal and state securities law.
- Procedures requiring certain employees to report personal securities purchases to the investment adviser.

Section 260.238.2

In general, this proposed rule will clarify practices involving “soft dollars.” These practices involve indirectly obtaining certain services by incorporating the charges for those services into client commissions. This proposed rule will incorporate Section 28(e) of the Securities Exchange Act of 1934 (“Exchange Act,” 15 U.S.C. § 78a et seq.).

This rule adopts the language of Section 28(e) of the Exchange Act which

establishes a safe harbor that allows money managers to use client funds to purchase “brokerage and research services” for their managed accounts under certain circumstances without breaching their fiduciary duties to clients. The scope of the term “brokerage and research services” is clarified in SEC Release No. 34-541365, (17 C.F.R. Part 241). The SEC release is partially incorporated into this proposed rule.

Section 260.238.3

In general, this proposed rule prohibits any investment adviser from paying a cash fee, directly or indirectly, to any solicitor with respect to solicitation activities unless certain conditions are met. The rule requires that the cash fee for solicitation activities must be paid pursuant to a written agreement, and also requires the solicitor to provide certain disclosures to clients. The rule requires an investment adviser to make a bona fide effort to ascertain whether the solicitor has complied with the conditions set forth in the parties’ agreement.

Section 260.238.4

This proposed rule requires an investment adviser to adopt and implement a business continuity plan. In general, the plan must specify how an investment advisory business would respond to emergencies of varying scope. The plan must be in writing and must specify how an investment adviser will address emergencies that disrupt the advisory business (e.g., alternative communications channels between an investment adviser and its clients). The plan must also provide certain specified safeguards for clients in the event of death or incapacitation of the investment adviser. The rule requires the investment adviser to disclose the nature of the plan to clients.

Section 260.241.3

The proposed amendments to this rule provide that all records (regardless of form, electronic or otherwise) must be arranged and indexed, promptly provided upon request, and duplicates separately stored from the original, based on the time preservation of the original record. Additionally, the rule will:

- Require that financial statements required to be maintained under the existing rule be prepared in accordance with General Accepted Accounting Principles.
- Amend the provision of the existing rule involving the retention of circulars or advertisement sent to individuals, to lower the number of persons that would trigger the retention requirement from 10 individuals to 2 individuals.
- Require the retention of written communications involving litigation regarding a written customer complaint.
- Require the retention of information regarding clients that is the basis for making any investment recommendation to such clients.
- Require the retention of written procedures to supervise employees.

- Require the retention of documents of each initial Form U-4 and each amendment to the disciplinary pages of Form U-4.
- Require the retention of certain specific documents, where the investment adviser inadvertently held or obtained a client's securities.
- Require the retention of documents that grant the adviser the authority to withdraw a client's funds or securities maintained with a custodian.
- Require the retention of certain specific documents that are acquired by the investment adviser from the issuer in a transaction not involving any public offering.
- Require the retention of certain documents necessary to form the basis for the calculation of the performance of all managed accounts or securities recommendations identified in any notice, or advertisement.
- Require the retention of certain documents in situations where an investment adviser has custody of securities or funds.
- Require the retention of documents showing what securities were purchased and sold, and amount and price of each purchase and sale.

AUTHORITY

Sections 25235, 25237, 25238, 25241 and 25610 of the Corporations Code.

REFERENCE

Sections 25230, 25235, 25236, 25237, 25238, 25241, and 25613 of the Corporations Code.

AVAILABILITY OF MODIFIED TEXT

The text of any modified regulation, unless the modification is only non-substantial or solely grammatical in nature, will be made available to the public at least 15 days prior to the date the Department adopts the regulation(s). A request for a copy of any modified regulation(s) should be addressed to the contact person designated below. The Commissioner will accept written comments on the modified regulation(s) for 15 days after the date on which they are made available. The Commissioner may thereafter adopt, amend or repeal the foregoing proposal substantially as set forth above without further notice.

AVAILABILITY OF STATEMENT OF REASONS, TEXT OF PROPOSED REGULATIONS/INTERNET ACCESS

The express terms of the proposed action may be obtained upon request from any office of the Department. Request Document PRO 27/03 - B. An initial statement of reasons for the proposed action containing all the information upon which the proposal is based is available from the contact person designated below. Request Document PRO 27/03 - C. These documents are also available at the Department's

website at www.corp.ca.gov. As required by the Administrative Procedure Act, the Office of Legislation and Policy maintains the rulemaking file. The rulemaking file is available for public inspection at the Department of Corporations, Office of Legislation and Policy, 1515 K Street, Suite 200, Sacramento, California 95814-4052.

AVAILABILITY OF THE FINAL STATEMENT OF REASONS

Upon its completion, the Final Statement of Reasons will be available and copies may be requested from the contact person named in this notice or may be accessed on the website listed above.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code section 11346.5, subdivision (a)(13), the Department must determine that no reasonable alternative it considered or that has otherwise been identified and brought to the attention of the Department would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed action.

FISCAL IMPACT

- Cost or savings to any state agency: None.
- Direct or indirect costs or savings in federal funding to the state: None.
- Cost to local agencies and school districts required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of the Government Code: None
- Other nondiscretionary costs/savings imposed on local agencies: None
- Costs to private persons or businesses directly affected: Insignificant or none.

DETERMINATIONS

The Commissioner has made an initial determination that the proposed regulatory action:

- Does not affect small businesses. Investment advisers are not small businesses under Government Code Section 11342.610(b)(1).
- Does not impose a mandate on local agencies or school districts, or a mandate that is required to be reimbursed pursuant to Part 7 (commencing with Section 17500) of Division 4 of the Government Code.
- Does not have an effect on housing costs.
- Does not have a significant statewide adverse economic impact directly affecting businesses, including the ability of California businesses to compete with businesses in other states.
- Does not significantly affect the creation or elimination of jobs within the State of California; the creation of new businesses or the elimination of existing businesses within the State of California; or the expansion of businesses currently doing business within the State of California.

COST IMPACTS ON REPRESENTATIVE PRIVATE PERSON OR BUSINESS

The Department is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

EFFECT ON SMALL BUSINESS

It has been determined that the adoption of these regulations will not affect small business. Under Government Code Section 11342.610(b)(1), investment advisers are not a small business.

CONTACT PERSON

Nonsubstantive inquiries concerning this action, such as requests for copies of the proposed regulation or questions regarding the timelines or rulemaking status, may be directed to Karen Fong at (916) 322-3553. The backup contact person is Marilyn Kaspar at (916) 322-3553. Inquiries regarding the substance of the proposed regulation may be directed to Colleen Monahan, Lead Corporations Counsel, Department of Corporations, 1515 K Street, Suite 200, Sacramento, California 95814, (916) 322-3553.

Dated: August 8, 2007
Sacramento, California

Timothy L. Le Bas
Deputy Commissioner
Office Legislation and Policy